STATE OF NEW JERSEY
OFFICE OF THE GOVERNOR

July 1, 2010

MEMORANDUM

To: The Honorable Christopher J. Christie, Governor
The Honorable Andrew Sidamon-Eristoff, Treasurer of New Jersey

From: **Governor's Council of Economic Advisors**
Robert E. Grady, Chairman
Richard F. Keevey, Member
Dr. Carl van Horn, Member

CC: Alfred C. Koeppe, Member
Arthur C. Ryan, Jr., Member
Richard H. Bagger, Chief of Staff to the Governor

RE: **Summary and Conclusions from June 2010 Meeting**
New Jersey Council of Economic Advisors
"Trends and Issues in Local Government Spending"

The Governor's Council of Economic Advisors, established by Executive Order 5 on January 20, 2010, held its second meeting on Monday, June 14, 2010, at 1:30pm Eastern Daylight Time, in Corwin Hall at Princeton University. The topic was "Trends and Issues in Local Government Spending". Governor Christie and Lieutenant Governor Guadagno attended and participated in the meeting.

The meeting focused on the growth in local government spending over the past few decades, trends in state aid to municipal and county governments, drivers of local spending growth, and options for reforming and curbing the growth of local government spending. This set of issues has emerged as central in the debate over the Governor's proposals, contained in his budget for Fiscal Year 2011, to provide local governments with a "tool kit" for controlling the growth of local spending and to cap the growth of property taxes at 2.5% per annum.

In attendance from the Council were Robert E. Grady, Richard F. Keevey, and Carl Van Horn. Several experts on the topic were invited to make presentations, as outlined in the agenda, which is attached, as are Power Point slides encompassing the materials of presenters who submitted such slides.

Also in attendance at the meeting as guests were the Governor's Chief of Staff Richard H. Bagger; the Governor's Counsel Jeffrey Chiesa; and the Governor's Cabinet Secretary Mr. Louis Goetting.

Members of the press also attended and reported on the session.

Introduction

Chairman Grady kicked off the meeting by outlining the agenda for the day and highlighting that local government spending had grown by 69% over the prior decade, outstripping the growth of state spending in New Jersey.

Overview from the Commissioner of Community Affairs

The Honorable Lori Grifa, Commissioner of the New Jersey Department of Community Affairs, highlighted key issues facing local governments in introductory remarks. Commissioner Grifa stated that "local officials are worried" about the "high cost of taxes", and resultant effects such as "senior citizens staying in their homes" because there were no buyers and the "middle class leaving the state." Noting both municipal spending growth and the fact that property taxes in New Jersey had risen by 70% over the past decade, Commissioner Grifa pointed out that the growth in municipal employee headcount had outstripped the growth of state employee headcount, and opined that "municipalities must find a way to cut the cost of doing business."

Commissioner Grifa discussed the Governor's proposed "tool kit", noting that collective bargaining reform and civil service reform would represent a needed break from the past, when "packages for uniformed services and others were accepted as a *fait accompli"*.

The Commissioner noted that, with building trades employment down as much as 40% in some localities, something had to be done to revive New Jersey's economy.

Trends and Pressures in Local Government Spending

Mr. Keevey moderated a first panel which included a variety of experts who outlined pertinent historical data and examined key trends in local and state spending.

Mr. Marc Pfeiffer, the Acting Director of the Division of Local Government Services in the New Jersey Department of Community Affairs, opened by reviewing a series of data regarding New Jersey's 566 municipalities, 21 counties, 180 fire districts, 300 local authorities, and over 590 school districts. The $12 billion that New Jersey's 566 municipalities spend ranks 14th among the United States in municipal dollars spent per 10,000 people, Mr. Pfeiffer said. Importantly, he noted that tracking municipal spending in New Jersey was quite difficult, as municipal government reporting relies on a fifty year-old paper-based system, employed non-standard GAAP reporting, and instead constituted a "modified cash basis" system of budgeting and reporting. Mr. Pfeiffer then reviewed pertinent data about the state's property tax base, consisting of 2.9 million parcels of land, with an assessed value of approximately $1.1 trillion (including $124 billion of non-taxable church, school and other public lands) and a market value of approximately $1.4 trillion, of which 76.8% was residential and 23.2% was commercial, industrial, apartments, and the like. Property taxes constitute approximately 55% of municipal revenues and state aid represents 14.9%. Mr. Pfeiffer noted that New Jersey municipal budgets have more than doubled in aggregate over the last 15 years, from $5.4 billion in 1994 to approximately $12.0 trillion in 2009.

Dr. Ernest Reock, Professor Emeritus at Rutgers University, also presented historical data regarding municipal spending and taxes, noting that while data on taxation is excellent, the data on municipal spending is weak. Professor Reock highlighted a series of "boom" and "recession" cycles in county, municipal and school tax receipts over the past 25 years, since 1985, with changes driven by such factors as the economic cycle, changes in state aid, changes in school enrollment, and the effect of statutory municipal tax caps. Dr. Reock called the period from 1986 to 1990 the "first boom", which was characterized in particular by extremely rapid growth in taxable property driven by large numbers of new properties being developed in the state, which in turn drove substantial, double-digit annual percentage growth in municipal and school revenues during those years. Dr. Reock identified the period from 1991 to 2001 as the "first recession", characterized by slower economic growth but very high growth in school enrollments, necessitating higher tax rates at the local level. Dr. Reock called the period from 2002 to 2006 the "second boom", but noted that strong growth in receipts from municipal and school levies in this period was more a result of "speculation in property values" than of growth in the number of properties being developed. Finally, he identified the current period since 2007 as the "second recession". Dr. Reock noted that the annual growth in total receipts from county, municipal, and school levies had averaged 6% during the 25-year period, but that there had been wide variability around that mean – from a high of 13.6% in 1988 to a low of 1.3% in 1991.

On a per capita basis, Dr. Reock presented data which showed a growth in municipal budgets of over 40%, from 2001 to 2008, from $949 to $1,376 per person. Property taxes covered virtually all of that increase, as other sources of municipal revenue – including miscellaneous local fees and revenue, state aid, surpluses, and delinquent taxes – were basically flat during the period. The result was a per person increase in property taxes of some 61% between 2001 and 2008, from $457 per capita to $736 per capita.

Mr. Robert Peden, the Deputy Director of the New Jersey Office of Management and Budget ("OMB") presented data on various categories of state spending, including State Aid and Direct Property Tax Relief, over the past 15 years, since 1995. Overall state spending averaged 5.2% annual growth during the period, with a high of 14.2% year over year growth in fiscal year 2005, a low of an 8.2% year over year reduction in fiscal year 2009. A recommended reduction in state spending of 5.3% was embodied in the Governor's fiscal year 2011 budget proposal, but because of the effects of the one-time stimulus in fiscal year 2010, the reduction in state funds plus stimulus funds was actually 8.7%. From fiscal year 2005 to the Governor's 2011 proposal, state aid as a percentage of the budget actually increased. State aid is proposed to be $11.97 billion in the Governor's FY 2011 budget, an increase over the $10.83 billion appropriated in FY 2005. Over the same time period, overall state spending is proposed to be reduced, from $28.56 billion spent in FY 2005 to a proposed $28.27 billion in the FY 2011 Governor's budget.

The data presented by Mr. Peden indicated that School Aid had grown faster than overall state spending in the last 15 years, with Direct School Aid increasing by 110% since 1995 while overall state spending grew by 84%. Certain categories have grown especially sharply, according to the data: School

Building Aid has increased by 500% during the period, and School Aid for Health Benefits and Social Security has increased by over 270%.

Total Direct Property Tax Relief is proposed for a reduction in the Governor's proposed FY 2011 budget, in part associated with savings and timing differences that will result from the proposal to change the system of administering Homestead Rebates from one in which the state mails out checks to one in which taxpayers are entitled to receive a tax credit directly on their tax returns.

Mr. John Megariotis, the Deputy Director of the Division of Pensions, reported on the magnitude of local government contributions to pensions and health benefits for local employees in recent years, and reported on the assets, liabilities, and funded ratios for local governments as employers. The data Mr. Megariotis presented data which showed, on average, substantial year-over-year dollar increases in net local employer contributions to Public Employee Retirement System (PERS) and Police and Fire Retirement System (PFRS) since FY 2004, even with phased-in or 50% contributions elected by local employers pursuant to Chapter 108, P.L. 2003 and Chapter 109, P.L. 2009. Nevertheless, data from the Division of Pensions shows that, despite these substantial increases, total local employer funded ratios, based on the actuarial value of local pension assets and accrued liabilities, has declined from 112% funded in fiscal year 2000 to 72% funded in fiscal year 2009. Meanwhile, expenditures by local government employers on employee medical benefits have grown from $443 million in FY 2003 to over $700 million in FY 2010, even though the total number of active and retired employees covered by such spending has remained relatively flat at just over 66,000.

Governor's Remarks

Governor Christopher J. Christie offered perspectives on property tax and spending growth in New Jersey. The fact that municipal spending had grown by 69% and property taxes had grown by 70% in the prior decade are not unrelated and in fact are highly correlated, the Governor pointed out. He highlighted the fact that his proposed cap on property tax growth at 2.5% per year was stronger than previous statutory property tax caps, both because of a lower allowed rate of growth but, importantly, because his proposal included only two exceptions to the cap: in order to service local debt and if local voters approve a higher rate of growth. The Governor also noted that without his proposed "tool kit" to allow municipal government to address the underlying drivers of local government cost growth, a cap would likely be ineffective.

The Governor related municipal spending growth to economic trends in the state, highlighting the fact that in 2009, private sector employment in New Jersey fell by 121,000, while the number of municipal employees actually grew by tens of thousands.

The Governor noted that he had signed into law a package of reforms regarding pension and health benefits for local employees on March 22, 2010, but stated that further reforms and tools were needed if the New Jersey was to attack successfully the problem of property tax growth.

Options for Reform

Treasurer Eristoff then moderated a panel on potential means of addressing the twin problems of local spending growth and property tax growth. He briefly outlined the components of the "tool kit" for local governments which the Governor had proposed as part of his FY 2011 budget. The tool kit is actually a package of 33 pieces of proposed legislation, addressing everything from civil service rules attendant to local and county employees, pension reform, collective bargaining reform, and state mandates to local and county governments.

The panel was led off by two representatives of the New Jersey League of Municipalities ("the League"), Gregory Fehrenbach and Brian Kronick, who outlined a series of positions taken and proposals made over recent years which would have the effect of reducing municipal costs and increasing the management flexibility of municipal governments. First, the representatives of the League addressed the issue of interest arbitration reform. Despite the fact that current statue requires arbitrators to consider nine factors in determining awards (including cap law limits, the welfare of the public, the financial impact on governing units and taxpayers, and others), the League representatives contended that arbitrators tend to place undue if not exclusive emphasis on one factor – comparability. This has resulted in high levels of increases to salary guides, clothing allowances, medical coverage, and other items without adequate regard for the cost to municipal employers, in the view of the League. The League representatives proposed a system in which the total cost of the arbitrator's awards – including step and COLA increases, medical and pension benefits, leave, vacations and the like – would not be allowed to exceed increases in the cost of living. The League representatives also called for reform in the process of selecting and reviewing arbitrators.

Messrs. Fehrenbach and Kronick also addressed a series of other issues of importance to municipal employers, and pleaded for increased flexibility from the state in allowing municipal officials to manage their responsibilities as employers and respond to the demands of various constituencies. Specifically, the representatives of the League called for:

- A return to the secret ballot process (which prevailed for four decades before 2005) in the organizing of municipal employees;
- Removal of onerous requirements to negotiate the impact of any decision to subcontract municipal services to outside or non-profit vendors;
- Removal of artificial "prevailing wage" requirements for contractors who provide municipal services; and
- Legislation and regulatory reform to allow municipalities to opt out of civil service, require involuntary furloughs, and reduce the time line to effect layoffs.

Dr. Henry Coleman, a Professor at Rutgers University, then presented an historical perspective on trends in aggregate spending by some 89,000 units of local government. Dr. Coleman asserted that from 1977 to 2000, local government spending (both in New Jersey and nationally) actually grew less than state and Federal spending, in part due to the effects of Proposition 13 in California and of the decline in Federal block grants to the states after 1981. Dr. Coleman's analysis indicated which areas of municipal spending have grown proportionally during the period (debt service, housing and community development, police services, and K-12 education), and which have declined (parks and recreation, fire, and highways and roads). Professor Coleman stated that "local government is in trouble" in the United States, citing National League of Cities estimates of a substantial, multi-billion dollar projected gap between the needs facing local governments in the United States and the resources available to them in the period from 2010-2012. He then recited a list of factors which have contributed to this gap, including the following: changes in population; demographic changes (including a growing average age, and growing populations of citizens under the age of 18 and of immigrants); the need to provide services to non-residents; higher traffic, crime, and infrastructure costs related to otherwise beneficial economic development; health care inflation effects on employee costs; slow penetration of technology in the provision of public services; and others.

The Property Tax Cap

A final panel, also moderated by Treasurer Eristoff, was comprised of two presenters who outlined issues related to the Governor's proposal to cap the annual growth of property taxes in New Jersey at 2.5%. Treasurer Eristoff pointed out that the cap was necessitated by the fact that the average property tax now paid by New Jersey families had grown to $7,281, an increase of almost 30% just in the last five years. According the Treasurer, the Governor's proposed cap allows only "one way out" of the 2.5% limit (passage of a local referendum to exceed it) and one exception to the calculation of the 2.5% cap (payments needed to service debt).

Mr. Gregg Edwards, Director of the Governor's Office of Policy Development, provided a brief summary of the features of the Governor's proposed property tax cap. The proposal is to cap property tax growth at 2.5% based on the levy of the prior year, including growth in ratables. The proposal as submitted to the Legislature would also allow municipalities to "bank" lower prior year increases in calculating the 2.5% cap.

Mr. Edwards also highlighted the differences between the Governor's proposal for New Jersey and property tax caps and limits which have applied in other states. California's widely-cited Proposition 13, passed in 1978, included both a limit of 2% in the annual growth of one's property tax assessment, and a cap on property taxes at 1% of assessed value. Prop 13 also did not allow for any override provision by local voters, Mr. Edwards noted.

The cap enacted in Massachusetts, passed by the voters in 1980 and implemented in 1982, was both a limit on the total amount a town could levy at 2.5% of assessed value and an annual cap of 2.5% growth above that limit. The Massachusetts constitutional amendment did provide that the 2.5% limit could be overridden by a popular vote of 50% or more of the votes cast (which has occurred 1,830 times since enactment), and that the new limit would be used as the base from which to calculate the limit in the following year. Mr. Edwards pointed out that since the time of enactment of Prop 2.5, Massachusetts has dropped from having the second highest tax burden in the country to having the 23rd highest, while New Jersey has gone from having the 10th highest tax burden in the nation to having the highest. Property taxes per capita (in constant, inflation-adjusted dollars), according to Mr. Edwards, increased during the period by 22% in Massachusetts and 102% in New Jersey.

Mr. Josh Barro, a Senior Fellow at the Hudson Institute, provided a more detailed examination of the results of the Massachusetts property tax cap. He asserted that the cap on property taxes enacted in Prop 2.5 allowed Massachusetts to live down its "Taxachusetts" label. He stated that the cap on property taxes was not offset in its entirety, as some have asserted, by extra-normal growth in state taxes and state aid. According to Mr. Barro, overall state and local taxes per capita, adjusted for inflation, grew by an average of 70% nationally from 1977 to 2007, and grew by 58% in Massachusetts and 108% in New Jersey. This did result in lower spending growth per pupil in Massachusetts schools compared to New Jersey. New Jersey went from spending 1% less per pupil than Massachusetts in 1980 to spending 26% more in 2007.

Despite radically lower growth in property taxes, lower growth in local government revenues overall, and lower school spending growth during the measured period, Mr. Barro indicated that Massachusetts had better educational outcomes than New Jersey. Massachusetts ranks number one among the states in performance on the National Assessment of Educational Performance ("NAEP") exams, and outscores New Jersey on grade 4 and 8 reading and math assessments – an advantage which persists across most demographic groups.

Mr. Barro concluded that Massachusetts Proposition 2.5 was highly effective in constraining property tax growth, and that nevertheless Massachusetts' schools were the top performers in the country, despite spending $3,000 less per student than those in New Jersey.

The meeting concluded at approximately 4:45pm EDT.

Conclusions and Recommendations:

It is clear that the growth of property taxes in New Jersey is a major economic and political issue facing the state. According to the Tax Foundation, the total state, county and local government burden placed on New Jersey citizens is the highest in the nation, and the 70% growth in local property taxes experienced over the past decade has been a major contributor to that fact.

The Council believes that it is appropriate, given the large role of New Jersey state government in financing municipal, county and school district budgets in the state, to provide local officials with more flexibility in addressing the drivers of spending growth and appropriate statewide tools in the negotiation of employment and pension agreements with their employees.

The Council observes that:

- School aid and state aid to municipalities have grown as a percentage of the overall state aid over the last 15 years.
- Costs for local government health benefits, in particular, have grown sharply even though the number of participants in local health plans has remained relatively stable.
- In total, costs for pensions and health benefits are growing at rates that are not sustainable. Unless something is done to reform these programs, the state will not be able to sustain payments from the system to participants.
- The growth in the total cost of awards given in interest arbitration have tended to outstrip growth in the cost of living as measured by inflation indexes, because of the effects of health and pension benefit provisions and other non-COLA factors included in total awards.
- Data on local government spending and trends related thereto is poor, and could benefit from increased investment in systems to increase the automation and standardization of reporting.

The Council therefore believes that providing local employers with increased tools to manage local employee costs is advisable. Current rules, requirements and processes in the areas of collective bargaining, civil service, and health and pension benefits sharply limit the flexibility of local government and are a significant driver of costs.

Finally, the Council endorses the Governor's proposal to establish a cap of 2.5% per year in the growth of local property taxes in New Jersey, with exceptions only for debt service and for cases in which local voters elect to allow taxes to rise at a greater rate. The current cap has too many exceptions which prevent it from functioning effectively. Specifically, the Council believes that placing a more binding limit on property tax growth, and reforming at the same time those rules which effectively limit the ability of local jurisdictions to control employee costs, would help address outmigration from the state. Capping property tax growth more effectively would make the state's tax environment more predictable, and restraining property tax growth and reforming archaic rules which hinder effective municipal governance would help address the adverse feature of New Jersey's environment as a place to live and work most often cited by those expressing concern.

# # #